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Congressional Testimony

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The Economic Outlook and the President's Budget Priorities, 2002–2011

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Mr. Chairman, members of the committee, thank you for the opportunity to testify on the economic and budget outlook. I must stress, however, that the views I express are entirely my own and should not be construed as representing any official position of The Heritage Foundation. I would like to focus on four key questions:

1. Is the economic forecast being used to guide policy accurate?
2. Are there policies that can affect the economy's performance?
3. What is the best use of the surplus?
4. Is government debt a serious problem?

The first question is easy to answer. Neither the CBO forecast nor the OMB forecast is accurate. But the fact that economists have never been able to predict the economy's short-term performance is not a cause for concern—as long as there is reason to believe that the errors are random and balance out over time.

In other words, a forecast is a good guide for policymakers if the average annual growth rate over the 10-year period is reasonably close—perhaps within 0.5 percentage points—to what actually happens. Using this more sensible performance standard, both CBO and OMB are basing their economic estimates on very reasonable predictions of the two key components of real GDP—population growth and productivity gains.

As such, there is no reason to believe that either forecast is systematically optimistic. Indeed, it is more likely that they are understating revenue growth over the next ten years—and thereby low-balling the surplus. This is not because the growth estimate is necessarily too pessimistic, but rather because the forecasts assume that tax revenues as a percent of GDP will decline slightly from today's record levels.

This is somewhat puzzling. As long as real income is increasing, and as long as we have a tax code that imposes harsher penalties on people for earning more income, tax collections should slowly climb as a share of economic output. The fact that the forecasts show just the opposite indicates that CBO and OMB are making some rather interesting assumptions. These assumptions may be reasonable, but this is an issue the committee may want to investigate.

The second question is whether certain policies can affect the economy's performance. This is a much more important topic to address. Many policymakers incorrectly are assuming that the economy's growth path is somehow independent of the fiscal policy decisions that will be made in the near future.

This is a mistake. Substantial reductions in tax rates will improve the economy's performance. Economists may disagree over the amount of additional growth that will be generated when tax rates are reduced, but one would be hard-pressed to find a credible economist who would say there is no effect. Likewise, one would find even stronger agreement that the economy will grow faster if lawmakers reduce the tax code's bias against savings and investment. This is why elimination of the death tax will result in additional economic output, particularly if the dramatic reduction in compliance costs and substantial improvement in the efficiency of investment are included in the estimate.

Tax policy is important, but it is not the only economic policy variable that deserves attention. Social Security reform could have profound consequences on future economic performance. The current system, a pay-as-you-go, tax-and-transfer scheme, reduces employment and lowers national saving. If America does what so many other countries have done and shifts to a system of personal retirement accounts, the impact on the economy's long-term performance would be quite significant.

Finally, no discussion of economic growth would be complete without addressing the size of government. Regardless of whether it is financed through taxes or borrowing, government spending represents a transfer of resources from the private sector to the public sector. If government spends that money in a way that generates a sufficiently high rate of return, the economy will benefit. If the rate of return is below that of investments in the private sector, however, then the rate of growth will be slower than it otherwise would have been. Unfortunately, most analyses indicate that the vast majority of government programs have low rates of return. Thus, if lawmakers can reduce the size of government—or at least limit its growth to 4% annually—this could free up resources that could be more efficiently used by the productive sector of the economy.

What does all this mean? If tax rates are lowered and the death tax is repealed, the economy will grow faster. This will enable more families to climb the ladder of opportunity. More important, for purposes of this committee, it will mean that tax cuts will not result in nearly as much foregone revenue as static forecasts suggest. My colleagues at The Heritage Foundation estimate that roughly half of the lost revenue will be recaptured as a result of improved economic performance. In simple terms, if a tax cut results in more income to tax, then there will be some level of revenue feedback. Similar "supply-side" estimates have been produced by economists at Harvard University and the American Enterprise Institute.

The third question is how best to use the surplus. This is the dominant debate on Capitol Hill, but it actually is a greatly overblown issue. Whether or not we have a surplus or a deficit is not nearly as important as whether we have a tax code that rewards productive behavior. It is likewise not as important as whether we can modernize the Social Security system. And it is not as important as whether we can impose some greatly needed discipline on the spending side of the budget.

In short, deficits and surpluses do not have much impact on the economy's performance. Self-proclaimed debt hawks asset that fiscal balance is important because interest rates will remain low, yet there is virtually no empirical evidence for this proposition. Indeed, the evidence actually suggests both fiscal balance and interest rates are dependent on the economy, not vice versa. In other words, a healthy economy will generate the tax revenues that balance a budget, but a healthy economy also will create attractive investment opportunities, and this will tend to bid up interest rates.

Moreover, changes in our fiscal balance are dwarfed by the sheer magnitude of international capital markets. Can anyone seriously believe that a $50 billion–$100 billion annual shift in the U.S. fiscal balance will have a noticeable impact on interest rates when more than $2 trillion changes hands every day in world financial markets?

Having issued caveats as to why this is not the right question, let me now suggest the best way to use the surplus. Lawmakers should focus on policies that will produce the greatest benefits for the people. This suggests both tax cuts and Social Security reform.

Tax cuts, more specifically lower tax rates and a reduction in double taxation of income that is saved and invested, will improve the economy’s performance and therefore create more opportunities for families to prosper. Indeed, because certain tax cuts have significant supply-side effects, the amount of tax relief can be much larger than the package proposed by the Administration. Remember, the $1.6 trillion figure is based on a static revenue estimate and the actual revenue loss will be far less than that amount.

Social Security reform is another desirable use of the surplus, though it should happen even if there were no surplus. Simply stated, the current system faces two crises. The first crisis is the gigantic long-term deficit. According to Social Security Administration figures, the inflation-adjusted deficit between 2015 and 2075 is a staggering $21.6 trillion. The other crisis is the fact that Social Security is an increasingly bad deal for workers. They are required to pay a record level of taxes into the system, but the benefits they are promised upon retirement are very meager.

America should learn from countries like Australia, Sweden, Chile, and England. Workers should be allowed to shift some portion of their payroll tax burden into a professionally managed personal retirement account. These private accounts would enable today’s workers to build a substantial nest egg that will provide a secure and comfortable income upon retirement.

An important component of any reform plan, however, is that current retirees and older workers should be given every penny of benefits that currently are promised. This guarantee could be fulfilled even if we did not have a surplus, but the extra money certainly will make this commitment easy to discharge.

Some would argue that the surplus should be used to reduce the national debt, which leads us to the final question. More specifically, is government debt a problem? The answer is yes, but not for the reason most people usually cite.

America’s national debt is a minor irritant. At just over $3 trillion, it is a small fraction of our annual income. Indeed, compared to other industrialized nations, our national debt is inconsequential. And the burden of debt will keep falling even if we don’t redeem a single bond—so long as the economy continues to grow. The national debt today, for example, is much bigger than the debt that was built up during World War II. But because our economy has expanded so much in the last 50+ years, the burden of the debt—measured as a share of GDP—is only one-third of its post-World War II high.

The real debt problem facing America is Social Security's unfunded liability. The program's long-term deficit is more than $21 trillion, roughly seven times bigger than the official national debt. This is the debt that threatens the well-being of future generations. And this is why Social Security reform is the issue that debt hawks should champion.

Critics complain that shifting to personal accounts will use up some of the surplus and therefore make it harder to pay off the debt. This is akin to not removing a tumor for fear of leaving a scar. Social Security reform may use up some of today's surplus, but the long-term reduction in the program's unfunded liability makes this one of the most effective investments that lawmakers can make.

Social Security reform is like refinancing a mortgage when interest rates drop. Yes, there may be some up-front costs, but the long-term savings will dwarf the short-term expense. This is why it is so misleading to talk about the "cost" of transitioning to a system of personal accounts. If lawmakers considered the total impact on government finances, Social Security reform is a big money-saver.

Thank you for the opportunity to discuss these important issues, and I look forward to answering any questions.

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